1040 News

Q3 2019

Quarterly news & tips for folks in every tax bracket

Introduction:

Summer is finally here. Take some time to relax and forget about financial matters. When you have a few moments in-between summer fun we have a few tax topics for you to read about. Page 1 covers a subject near and dear to all parents… their kids. If you don't have kids then turn the page for summertime tax tips that pertain to everyone.

Summer Jobs:

If your kids have summer jobs there are a few simple tax concepts they should understand. Before we get into the details it matters what type of job they have… employee vs. independent contractor.

Most summer jobs are employee positions. Employees can earn up to $12,000 a year (grand total for all jobs with no other types of income) and not owe any ordinary federal tax. The only tax they owe is Social Security and Medicare, which is about 7.5% of their pay. Social Security and Medicare are taken directly out of their paycheck. If they make more than $12,000 then they should have additional tax withheld from their paycheck on top of Social Security and Medicare. To accomplish this they need to understand the W-4 form.

The W-4 governs how much federal withholding is taken out of their paychecks. If they will make less than $12,000 then they can simply write "exempt" in box 7 of the form. Aside from preventing unnecessary withholding this will save time and money by eliminating the need to file a 2019 federal tax return. If they will make more than $12,000 then they should probably claim "single" with 1 "allowance" on the W-4. In most cases this will generate enough withholding to result in a small refund on their 2019 federal tax return. However, if they have several small jobs then they are likely better off claiming single and 0 (zero) on the W-4. That's because the formula that determines how much to withhold doesn't know about their other sources of income. Understanding this concept is valuable for their entire working life so they should learn about it now.

What about state withholding? In most states you should claim the same marital status and number of allowances for state tax withholding as you do on the federal W-4. However, some states do not conform to the federal rules so ask your tax advisor if your situation requires something different.

What happens if your kids are independent contractors? They will not have withholding taken out of their paychecks, so they will have to file a federal income tax return (unless they make less than $400). The good news is that independent contractors can deduct job related expenses that are not reimbursed by the company that hired them. They may even be able to get a deduction if they drive their own vehicle on the job. In short, tell your kids to keep track of their job related expenses and mileage. Also tell them that if they don't pay their taxes in quarterly estimates throughout the year they may have a big balance due (and potential penalties) when they file their tax return. Lastly, to avoid surprises encourage them to work with a tax advisor to estimate and make their quarterly payments.

Saving for Retirement:

As soon as your kids start making money they should be saving for retirement. Specifically, a Roth IRA makes the most sense for kids because they have decades for the investment to grow. If invested successfully, a small Roth IRA contribution could grow into a large amount of tax free retirement income. Even if they choose not to contribute their own money you should find another source to fund their Roth. Perhaps a gift or loan from parents and/or grandparents can be used?

Any type of earned income (even paid chores like babysitting & lawn mowing) allows your kids to contribute to a Roth IRA. The amount that can be contributed is limited to the amount of their earned income during the year. Also remember that the maximum amount that can be contributed for 2019 is $6000. You have until 4/15/2020 to make the contribution for tax year 2019.

College Bound?

If your kids are in college already (or starting in the fall) you should try to qualify for the American Opportunity Credit. The credit amounts to $2500 per year per student and can be claimed up to four times for each student (for the first four years of college). There are several factors, but the most common disqualifier is making too much money. Married couples must file jointly and keep their adjusted income below $160,000 to claim the full amount of the credit (for non married folks the amount is $80,000). If you are close to those limits you may want to increase your pre-tax deductions (such as 401k and/or HSA/flex-spending contributions) in order to reduce your adjusted income and qualify for the credit. There are several other qualifiers too. For instance, you need to be able to claim the kid as a dependent. Work with your tax advisor to plan ahead if you think you might qualify.

Turn the page for 3rd quarter tax saving tips.

Tax Tips for 3rd Quarter, 2019

Here is a grab-bag of tips to ponder while enjoying the summer. We will intentionally leave out many of the technical details. Work with your tax advisor to understand precisely how these tips pertain to you.

Did you file an extension for 2018?

Don't wait until the last minute to get your 2018 taxes done. Believe it or not, the most common downside to procrastination is memory loss. It becomes harder to remember which income and/or expense events took place during 2018 and which spilled over into 2019. Get your taxes done before you forget the details.

Did you owe for 2018?

More taxpayers had a balance due for tax year 2018 due to changes in federal withholding. *1040 News* has written extensively about this topic. See back-issues for details. Practically speaking, if you owed last year you should change your withholding now because there are still several pay periods remaining in 2019… so there is enough time for the changes to make a difference.

Do you need to amend a return?

Now is a good time to amend tax returns because your tax advisor has more time. Don't wait until next tax season. This is especially true if you need to amend a 2016 return because it will expire on 4/15/20. Most taxpayers know when they need to amend. Either you missed the mark on your income and/or deductions or someone else did. Corrected (or late arriving) financial statements are a common cause of amended returns. If someone else caused the problem you should ask them to pay for your amended return preparation fees.

Did you get a raise?

If you got a raise in 2019 you should consider increasing your retirement savings (if you are not already contributing the max) by the amount of your increased take-home pay. It is easier to do this when you get a raise because your cash flow does not go down.

Did you exercise stock options?

If you exercised stock options in 2019 you should take a close look at your most recent pay stub. A common problem with stock options is they don't withhold enough to cover the tax liability. Amazingly, even taxpayers that claim "single & zero" on their W-4 form still can experience this problem. If you don't know how to interpret your paystub or how much they were supposed to take out then ask your tax advisor for help.

Did you start a business?

Start saving your receipts and keeping track of your income and expenses immediately after starting your business. Then schedule an appointment to chat with your tax advisor. Be prepared to answer questions about what type of business you formed and whether or not you have any other business partners. It is also wise to approximate your income and expenses for the entire year ahead of time to determine how much (if any) you should be paying in estimated taxes. Paying estimated taxes correctly can avoid costly penalties.

Did you sell a home?

The tax implications of selling a home depend on the type of home it is. If you sell rental property you probably will owe tax. Talk to your tax advisor to figure out how much. If you sell the home that you live in (with no rental history) then you probably won't owe any tax unless you profited more than $250,000 ($500,000 for a married couple on a jointly filed return). However, don't automatically assume that you won't owe tax as you may not qualify for the $250,000 exclusion or there may be other factors that generate tax. For example, if you claimed an office in the home deduction for any year you owned the property there are likely tax implications.

Did you sell investments?

Investments you sell for a profit will likely result in tax owed. If you sell investments for a loss you might be able to deduct it on your taxes (with limitations). If the dollar amounts are large it is wise to estimate the gain or loss in advance.

Did you inherit something?

The tax rules for inheritance are generally favorable. For example, cash inheritances are not taxable. Pay closer attention to inherited financial accounts though. If you inherit an IRA you will soon have to make required distributions from the account and pay tax on the amount distributed. If you inherit a bank account or brokerage account you will be responsible for paying tax on the interest, dividends, and capital gains the account earns after you become the owner. The good news, however, is that you receive a "stepped-up-basis" on inherited assets. Practically speaking, that means that if you sell the assets before they have a chance to appreciate you will not realize a taxable capital gain.

Did you receive gifts?

Gifts also have favorable tax rules. For starters, gifts of cash are non taxable income (no matter how large). Gifts of investments or property will have tax implications if you sell them. That's because you do NOT receive a stepped-up-basis for gifts. Rather, the donor's basis becomes your basis when you receive the gift.

Will you turn age $70^{1/2}$ in 2019?

If you read this newsletter every quarter you know that we are trying to raise awareness about Qualified Charitable Distributions (QCD). That's when you give a portion of your annual Required Minimum Distributions (RMD) directly to charity. Most taxpayers will save more in tax dollars by giving this way. See back-issues of *1040 News* for details and ask your tax advisor if QCDs will work better for you. If you are younger than $70^{1/2}$ you should consider increasing your retirement contributions. Hopefully you will retire rich and can give your RMDs to charity (as long as lawmakers don't change the rules).

Time is running out on residential energy credits.

2019 is the last year for the full 30% credit on qualifying residential solar, wind, geothermal, & fuel cell purchases. The credit drops to 26% in 2020. Don't forget that the system needs to be fully installed by 12/31/19 to qualify for the full 30% credit.

Thanks for reading. Look for our next issue in August.